Nos. 20799-20801

In the United States Court of Appeals for the Ninth Circuit

MIRRO-DYNAMICS CORPORATION, APPELLANT

v.

UNITED STATES OF AMERICA, APPELLEE

ON APPEAL FROM THE JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF CALIFORNIA

BRIEF FOR THE APPELLEE

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OPINION BELOW

The decision of the District Court is reported at 47 F. Supp. 214. The findings of fact and concluions of law (R. 277–284) [1] are not officially reported.

JURISDICTION

This appeal involves federal income taxes. The axpayer claims to have overpaid its federal income axes for its fiscal years ended October 31, 1958, 1959, 960. (R. 3, 303, 334.) Claims for refund totalling 517,909.33 were filed on September 6 (R. 4, 336) and ovember 8, 1963 (R. 305). Within the time provided 1 Section 6532 of the Internal Revenue Code of 1954, n May 22, 1964, the taxpayer brought these actions

[1] "R" references are to the Transcript of Record on appeal.

in the District Court for the recovery of taxes paid (R. 2, 303, 334). Jurisdiction was conferred on the District Court by 28 U.S.C., Sections 1340, 1346 (a)(1). The actions were consolidated for trial and decision. (R. 52, 235, 278.) Summary judgment was entered on November 23, 1965. (R. 286.) Within 60 days, on January 19, 1966, a notice of appeal was filed. (R. 289.) Jurisdiction is conferred on this Court by 28 U.S.C., Section 1291.

QUESTIONS PRESENTED

(1) Whether the District Court correctly held that losses from the sale of securities by the taxpayer were capital losses.

(2) Whether the District Court correctly held that the taxpayer could not properly inventory its securities.

(3) Whether the District Court properly granted a motion for summary judgment in favor of the Government.

(4) Whether the District Court correctly held that the federal stock transfer taxes paid by the taxpayer were not currently deductible.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations are set forth in the Appendix, *infra*.

STATEMENT OF FACTS

The material undisputed facts in this case are as follows. The taxpayer is a California corporation located in Los Angeles. Prior to April, 1961, the taxpayer manufactured and sold sliding glass doors under

the names Fullview Corporation and Pacific Bolt Corporation. (R. 5, 65.) In the spring of 1961, it sold substantially all of the assets of its manufacturing business and received over one million dollars in cash. (R. 5, 71.) The taxpayer changed its name to Mirro-Dynamics Corporation, discontinued its sliding glass door business, and opened accounts with brokers in order to engage in the buying and selling of securities. (R. 5, 71–72.) Within a few months it had purchased over $3,000,000 worth of securities in hundreds of different transactions. (R. 5, 7–12.) During its next year, fiscal year ended October 31, 1962, the taxpayer sold securities worth over $4,000,000 and incurred a net loss of close to $900,000. (R. 5, 13–21.) The taxpayer paid federal stock transfer taxes on the transfer of securities for 1962. (R. 243, 281.)

The taxpayer admits that it bought and sold securities solely for its own account. (Br. 39; R. 237, 282.) The public placed no orders with the taxpayer to buy and sell securities. The taxpayer did not advertise to obtain business, for it was not a member of any stock exchange, or licensed as a broker-dealer with the Securities and Exchange Commission, or permitted by California law to conduct a business of selling securities to the public or of buying securities for the purpose of resale. (R. 5, 128–130, 135, 185–C, 237, 282, 306, 337.)

In the District Court, the taxpayer claimed that the loss it incurred in 1962 on the sale of its securities was an ordinary loss which could be carried back as a net operating loss to 1959 and 1960, producing a tax refund for those years. (R. 231.) The Government

contended that the loss was a capital loss and, thus, did not qualify as a net operating loss. (R. 237.) The taxpayer also claimed that as a consequence of repricing its closing securities inventory for 1961, it was entitled to an additional net operating loss to be carried back to 1958. (R. 236.) The Government contended that the taxpayer was not a dealer in securities and therefore could not inventory its securities at all. (R. 239.) Finally, the taxpayer claimed a current deduction for federal stock transfer taxes it paid on the transfer of securities for 1962. (R. 236.) The Government took the position that those payments were not currently deductible but should be added to the basis of the securities, reducing any gain or loss on sale. (R. 241.) The Government moved for summary judgment (R. 186), and the District Court held that on the undisputed facts, the Government was entitled to judgment as a matter of law. (R. 286–287.)

SUMMARY OF ARGUMENT

1. Upon receiving over one million dollars in cash from the sale of the assets of its manufacturing business, the taxpayer opened accounts with brokers and busied itself buying and selling securities. Its purchases and sales of securities were exclusively for its own account. Not being licensed as a broker-dealer in California, it was prohibited by law from having customers. Unable to buy or sell directly on a stock exchange or in the over-the-counter market, its source of supply of securities could be no different than that

f anyone else with the same available amount of noney.

Faced with a substantial net loss as a consequence of ts securities activities, the taxpayer seeks the tax dvantage of having its losses treated as ordinary osses rather than capital losses from the sale of apital assets. Its central argument appears to be hat its securities are not capital assets but that they vere held for sale "to customers" in the ordinary ourse of business. In view of the status of the assets nd the taxpayer, however, it is difficult to see how it ould have customers—except in the sense that any ale of securities is a sale to an ultimate customer. But the taxpayer contends that only the status of the sset is important; the status of the holder of the sset is unimportant. If that were true, then gain r loss on the sale of securities—the clearest kind of "natural" capital assets—would always be capital. The taxpayer goes on to claim that so long as one is n business, all sales are made "to customers." Except for the precise type of activity we are concerned vith in this case—buying and selling securities and imilar rights—that proposition may well be true.

When Congress added the term "to customers" to he predecessor of Section 1221(1) it sought thereby o halt the revenue loss caused by excessive deductions f securities losses by non-dealers. The fact that the ecurities activity may rise to the level of a business lue to the expenditure of a large amount of time, ttention, and funds and may therefore produce losses f even greater magnitude is all the more reason for reating such losses as capital losses. The legislative

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purpose of the "to customers" language also explains why the *Corn Products* doctrine—everyday business profits and losses are ordinary income and losses—is inapplicable in this case. Even as to commodity futures, the precise assets involved in *Corn Products,* it has consistently been held that gain or loss from the business of trading futures (as opposed to hedging) is capital gain or loss.

The undisputed facts of this case establish that this taxpayer could not have held securities for sale "to customers" within the meaning of the statute. For similar reasons, the taxpayer could not properly inventory its securities. Accordingly, the District Court properly granted a summary judgment on these issues in favor of the Government.

2. The District Court also correctly held that federal stock transfer taxes paid by the taxpayer on the purchase and sale of securities for 1962 are not currently deductible. The Code contains no specific provision permitting such taxes to be deducted. To qualify as deductions, the stock taxes would have to come within the general business expense provision, Section 162. One limitation of that section is the principle that capital expenditures—*e.g.* costs directly connected to the acquisition and disposition of capital assets—are not currently deductible. A tax payable only on the transfer of capital assets (the securities in this case) can scarcely be more directly connected to the acquisition and disposition of capital assets. Accordingly, the federal stock transfer tax should be added to basis, thereby reducing the amount of gain or loss on sale of the stock.

ARGUMENT

I. The District Court correctly held that losses from the sale of securities by the taxpayer were capital losses

A. Introduction

When the taxpayer sold substantially all the assets of its manufacturing business in 1961, it received over one million dollars in cash. (R. 5, 71, 237, 282, 306, 337.) Instead of distributing the cash to its shareholders in liquidation, the taxpayer opened accounts with brokers, devoted itself exclusively to buying and selling securities, and purchased over $3,000,000 of securities within a few months. (R. 5, 135, 237, 282, 306, 337.) The taxpayer was not a member of any stock exchange, or licensed as a broker or dealer by the Securities and Exchange Commission, or licensed by California to sell securities to the public. (R. 128, 129–130, 237, 282.) Accordingly, the public placed no orders with the taxpayer to buy or sell securities, and the taxpayer bought and sold securities solely for its own account. (R. 5, 129, 185–C, 237, 282, 306, 337.)

From the sale of securities in 1962, the taxpayer claims a net loss of close to $900,000. (R. 74.) There is no dispute that the loss was incurred. The issue is whether it is an ordinary or a capital loss. If an ordinary loss, it may be carried back as a net operating loss to 1959 and 1960, producing a tax refund for those years. Section 172, Internal Revenue Code of 1954, Appendix, *infra*. On the other hand, if the loss is a capital loss, it does not qualify as a net operating loss and may be carried forward to future years only. Sections 172(c), 1211(a), Internal Revenue Code of 1954, Appendix, *infra*. The characterization of the

taxpayer's net loss as capital or ordinary turns on whether the securities it sold were capital assets.

B. The securities were capital assets

To determine whether the District Court was correct in holding (R. 241, 283) that the securities were capital assets, we start with the words of the applicable statute. Section 1221 of the Internal Revenue Code of 1954, Appendix, *infra,* provides, with certain exceptions, that "the term 'capital asset' means property held by the taxpayer (whether or not connected with his trade or business)." The taxpayer's securities satisfy that definition. The issue is whether they fall within the exceptions contained in Section 1221 (1) which provides that a capital asset does not include:

> stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business; * * *

The securities of the taxpayer are not properly includible in its inventory.[2] The basic inventory section allows securities to be included in inventory only by a dealer—*i.e.* "a merchant of securities * * * regulary engaged in the purchase of securities and their resale to customers * * *." Treasury Regulations on

[2] Since the taxpayer may not properly inventory its securities at all, *a fortiori* it may not reprice its closing "inventory" of securities for 1961 and obtain an increased net operating loss deduction to be carried back and used for the year 1958. (R. 239, 241, 281, 283, 303, 307.)

[ncome Tax (1954 Code), Sec. 1.471–5; Appendix, *infra.* That regulation goes on to provide that taxpayers "who buy and sell or hold securities for investment or speculation, irrespective of whether such buying or selling constitutes the carrying on of a trade or business * * * are not dealers in securities * * *." Taxpayers which buy and sell securities for their own account (as did this taxpayer (R. 5, 128–130, 237, 282)) are not dealers but are traders or investors and may not inventory their securities. *Schafer* v. *Helvering,* 299 U.S. 171 (1936); *Helvering* v. *Fried,* 299 U.S. 175 (1936); *Commissioner* v. *Burnet,* 40 B.T.A. 605 (1939), affirmed in part, 118 F. 2d 661 (C.A. 10th, 1935); *Adirondack Securities Corp.* v. *Commissioner,* 23 B.T.A. 61 (1931); *Oil Shares, Inc.* v. *Commissioner,* 29 B.T.A. 664 (1934). As the District Court held, the taxpayer's (R. 241) "Securities do not constitute business inventory within the meaning of the Internal Revenue Act."

The taxpayer argues (Br. 35–41) that even though its securities are not includible in inventory under Section 471, they are, nevertheless, includible in inventory under Section 1221(1). The taxpayer does not support its reading of the term "inventory" either by legislative history or decisional law. We have found nothing that gives the vaguest indication that Congress intended "inventory" to mean one thing in Section 471 and something entirely different in Section 1221(1). When faced with the question of whether securities are properly includible in inventory, courts have consistently taken the position that the standard under Section 1221(1) and Section 471

is the same. *Commissioner* v. *Burnet, supra; Van Suetendael* v. *Commissioner,* decided September 25, 1944 (P–H Memo T.C., par., 44, 305), affirmed *per curiam,* 152 F. 2d 654 (C.A. 2d, 1945); *Adnee* v. *Commissioner,* 41 T.C. 40 (1963); *Farr* v. *Commissioner,* 44 B.T.A. 683 (1941).

The main argument of the taxpayer (Br. 41–55) is that its securities come within the last exclusion of Section 1221(1)—*i.e.* they were "held * * * primarily for sale to customers" in the taxpayer's business. As the taxpayer interprets that exclusion, the words "to customers" as applied to securities are mere surplusage since *any* sale of securities in the course of business (Br. 9) "is to 'a customer'." Such a skewed interpretation is possible only by disregarding the clear intention of Congress and the weight of judicial authority.

The legislative history of that particular exclusion is rather well known.[3] Prior to 1932, property was excluded from the definition of a capital asset if "held by the taxpayer primarily for sale in the course of his trade or business" and short-term securities losses could be offset in an unlimited amount against ordinary income. Revenue Act of 1928, c. 852, 45 Stat. 791, Sec. 101. Congress was prompted to change the law by the disclosure that some taxpayers were using securities losses generated by the depression to

[3] See generally, American Law Institute, *Definitional Problems in Capital Gains Taxation*, Discussion Draft, pp. 330–331 (Oct. 20, 1960); Miller, The "Capital Asset" Concept: A Critique of Capital Gains Taxation: 1, 59 Yale L. Journal 837, 844–845 (1950); Latham, Taxation of Capital Gains, 23 Calif. L. Rev. 30, 34 (1935).

offset income from all other sources and were paying no federal income tax. In the Revenue Act of 1932, Congress singled out stocks and bonds to provide that short-term losses on the sale or exchange of stocks or bonds were deductible only to the extent of such gains. Revenue Act of 1932, c. 209, 47 Stat. 169, Sec. 23(r). That restriction applied to traders and investors but not generally to dealers in securities which were defined as:

> a merchant of securities, whether an individual, partnership, or corporation, with an established place of business regularly engaged in the purchase of securities at wholesale and their resale to customers * * * Traders or other taxpayers who buy and sell securities for investment or speculation, whether or not on their own account, and irrespective of whether such buying or selling constitutes the carrying on of a trade or business, are not regarded by your committee as dealers in securities * * *. H. Rep. No. 708, 72d Cong., 1st Sess., p. 13 (1939–1 Cum. Bull. (Part 2) 457, 466); S. Rep. No. 665, 72d Cong., 1st Sess., p. 19 (1939–1 Cum. Bull. (Part 2) p. 496, 510), p. 19.

In the Revenue Act of 1934, Congress sought to accomplish the same result by amending the definition of capital assets so as to exclude not all property held primarily for sale in the course of business, but only such property as was held primarily for sale "to customers" in the "ordinary" course of business. Section 117, Revenue Act of 1934, c. 277, 48 Stat. 680. It was asserted that this amendment would make it "impossible to contend that a stock speculator trading

on his own account is not subject to the provisions" of the predecessor to Section 1221. H. Conference Rep. No. 1385, 73d Cong., 2d Sess., p. 22 (1939–1 Cum. Bull. (Part 2) 627, 632); Cf. S. Rep. No. 558, 73d Cong., 2d Sess., p. 12 (1939–1 Cum. Bull. (Part 2) 586, 595.

The standard explanation of the "to customers" rule in the securities area is contained in *Kemon* v. *Commissioner,* 16 T.C. 1026, 1032–1033 (1951):

> Those who sell "to customers" are comparable to a merchant in that they purchase their stock in trade, in this case securities, with the expectation of reselling at a profit, not because of a rise in value during the interval of time between purchase and resale, but merely because they have or hope to find a market of buyers who will purchase from them at a price in excess of their cost. *This excess or mark-up represents remuneration for their labors* as a middle man bringing together buyer and seller, and *performing the usual services of retailer or wholesaler of goods.* * * * Such sellers are known as "dealers."
>
> Contrasted to "dealers" are those sellers of securities who perform no such merchandising functions and whose status as to the source of supply is not significantly different from those to whom they sell. That is, the securities are as easily accessible to one as to the other and the seller performs no services that need be compensated for by a mark-up of the price of the securities he sells. The sellers depend upon such circumstances as a rise in value or an advantageous purchase to enable them to sell at a price in excess of cost. Such sellers are known as "traders." [Italics added.]

The important point is that the term "customers" refers to a merchandising function that is performed only by a dealer. He obtains his profit or mark-up in return for services which he performs in keeping a supply of securities on hand and permitting the customer access to that supply. Whether the dealer's mark-up is in the form of commissions, fees, differentials, or price spreads, he differs from the trader who performs no such merchandising functions and who depends wholly on the rise or fall of the market for his profit. Thus, it has been held consistently that one who trades for his own account does not sell "to customers"—he is his own customer. See *e.g. Commissioner* v. *Burnett,* 40 B.T.A. 607 (1939), affirmed in part, 118 F. 2d 661 (C.A. 5th, 1941); *Faroll* v. *Jarecki,* 231 F. 2d 281 (C.A. 7th, 1956), certiorari denied, 352 U.S. 830 (1956). On the other hand, one who trades on the floor of an exchange with other professionals as a specialist does sell "to customers" for the reason that he performs a merchandising function. He is required by the rules of the exchange to maintain orderly markets in the securities he specializes in, and he is known to be ready and able to satisfy any demand for those securities within the limits of his supply. *Farr* v. *Commissioner,* 44 B.T.A. 683 (1941); cf. *Vaughan* v. *Commissioner,* 85 F. 2d 497 (C.A. 2d, 1936); *Schafer* v. *Helvering,* 299 U.S. 171 (1936).

Perhaps the best illustrations of the governing principle are those cases where a taxpayer in the business of buying and selling securities for customers for the customary fee decides to buy and sell for his own

account—with the prospect of profiting on the rise o fall of the market. It is well settled that these latte transactions must be separated out from the regula merchandising operation and subjected to capita asset treatment. *Van Suetendael* v. *Commissione* decided September 25, 1944 (P–H Memo T.C., pa 44,305), affirmed *per curiam,* 152 F. 2d 654 (C. A. 2 1945); *Stifel, Nicholaus & Co.* v. *Commissioner,* 1 T.C. 755 (1949); *Van Tuyl* v. *Commissioner,* 12 T.C 900 (1949); *Carl Marks & Co.* v. *Commissioner* 12 T.C 1196 (1949); cf. Section 1236, Internal Revenue Cod of 1954.

The undisputed facts of this case establish that thi taxpayer was in no position to perform any mer chandising functions. Like any non-dealer, the tax payer bought and sold securities (Br. 39) "solely fo its own account." Like the ordinary taxpayer in terested in the market, it bought and sold securitie primarily through brokers. (R. 5, 185–C, 306.) Th taxpayer was not a member of any stock exchange or registered with the S.E.C. as a broker-dealer, o even licensed to sell securities in California. (R 128–130, 237, 282.) Accordingly, it could not accep buy and sell orders.[4] It could not place such order directly on any stock exchange. It could not buy o

[4] The taxpayer conducts its business in California where it i incorporated. (R. 5, 65.) California law prohibits a corpora tion from engaging without a license in the business "of selling offering for sale, negotiating for the sale of, or otherwise deal ing in, any security issued by others * * * or of underwriting any issue of such securities, or of purchasing such securitie with the purpose of reselling them, or of offering them for sal to the public." Corporations Code, 25 West's Annotated Cali fornia Codes, Sec. 25006. See also, *id.*, Secs. 25700, 26104.

sell securities directly on the over-the-counter market,[5] nor could it buy or sell securities from or to the general public.[6]

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[5] Unless registered with the Securities and Exchange Commission, no broker or dealer may transact interstate business on the over-the-counter markets. Securities Exchange Act of 1934, c. 404, 48 Stat. 881, Sec. 5 (15 U.S.C., 1964 ed., Sec. 78(e)), and Sec. 15, as amended by Sec. 3, Act of May 27, 1936, c. 462, 49 Stat. 1377 (15 U.S.C., 1964 ed., Sec. 78(o)). See also fn. 4, *supra*.

[6] The above undisputed facts based on the pleadings, admissions, answers to interrogatories, and depositions support the grant of summary judgment in favor of the Government on the capital loss issue as a matter of law. The District Court correctly so held. (R. 237, 278, 283.) The taxpayer, however, argues that a summary judgment was improper for three main reasons: (1) The affidavit in support of the Government's motion for summary judgment was inadequate (Br. 11–14); (2) Absent that affidavit, the motion should be treated as a "judgment on the pleadings" (Br. 14–15); (3) The District Court could only consider the pleadings in deciding that motion (Br. 15–35). On the contrary, the primary purpose of the summary judgment procedure is to pierce the allegations of the pleadings by other materials which establish that the movant is entitled to judgment as a matter of law. *Bushman Const. Co.* v. *Conner*, 307 F. 2d 888, 892 (C. A. 10th, 1962) (quoted on p. 27 of taxpayer's brief); *Burnham Chemical Co.* v. *Borax Consolidated, Ltd.*, 170 F. 2d 569, 573 (C. A. 9th, 1948); *Lindsey* v. *Leavy*, 149 F. 2d 899, 902 (C. A. 9th, 1945); *Dressler* v. *MV Sandpiper*, 331 F. 2d 130, 132 (C. A. 2d, 1964); *St. Helena Parish School Board* v. *Hall*, 287 F. 2d 376, 378–379 (C. A. 5th, 1961). The presentation of information by way of affidavit on the part of the movant is permissive and not mandatory. Rule 56(c), Fed. Rul. Civ. Proc., 28 U.S.C. 56(c). In this case, the affidavit contains no material facts that are not also found in the pleadings, admissions, depositions, and answers to interrogatories. The District Court could properly consider those materials and it expressly did so. (R. 237, 278.) Finally, regardless of other facts concerning the everyday operation and activities of the taxpayer's business, the above

That the taxpayer had sizable sums of money at its disposal and engaged in activity commensurate with its funds does not make it any more a dealer in securities or any less a trader or investor. *Faroll* v. *Jarecki, supra; Kemon* v. *Commissioner, supra.* The taxpayer, however, relies extensively on the doctrine that profits and losses arising from the everyday operation of a business are ordinary income or losses. *Corn Products Refining Co.* v. *Commissioner,* 350 U.S. 46, rehearing denied, 350 U.S. 943 (1955). We have no quarrel with that doctrine except to point out that this case concerns the exception to that rule. In *Corn Products,* a manufacturer of products made from grain corn bought commodity futures as a hedge against price increases in raw materials needed in its core business of manufacturing. The Supreme Court held that the gain from the sale of those futures was ordinary income. Where by way of contrast the core "business" of the taxpayer is buying and selling futures (or similar rights) for its own account, any gain or loss is capital. *Faroll* v. *Jarecki, supra; Commissioner* v. *Covington,* 120 F. 2d 768 (C. A. 5th, 1941); *Commissioner* v. *Burnett,* 118 F. 2d 659 (C. A. 5th, 1941); *Wood* v. *Commissioner,* 16 T.C. 213 (1951). There is no inconsistency in the two results. Both are derived from legislative purpose. While there is a general congressional intent that everyday business profit and loss be ordinary income or loss, Congress has also created an exception to that gen-

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undisputed facts show as a matter of law that the taxpayer could not have held securities primarily for sale "to customers" within the meaning of Section 1221(1).

eral rule, as we have seen, so that any loss or gain on the sale of securities by a trader or investor is capital loss or gain.[7]

The taxpayer also relies on cases involving other assets, particularly real estate, for the proposition that the term "to customers" adds little to the primarily-held-for-sale provision. (Br. 41–55.) Again, we have no quarrel with that proposition as applied to other assets. It is abundantly clear from the express purpose of Congress and from subsequent judicial interpretation that the term "to customers" creates an additional requirement in the case of stock or similar rights and not, for example, in the case of real estate. The taxpayer, however, argues that the Government took the position in *Malat* v. *Riddel,* 383 U.S. 569 (1966) that so long as one is in business (Br. 9) "any

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[7] *United States* v. *Chinook Inv. Co.*, 136 F. 2d 984 (C. A. 9th, 1943) which the taxpayer purports to rely on (Br. 38–48) is distinguishable. In that case, this Court upheld a finding of the trial court that the taxpayer held its securities for sale "to customers" so that its securities losses were ordinary. Under the laws of the state where the taxpayer conducted its business, it appears to have been able to sell securities to the public. In considering the activities of that taxpayer, this Court concluded that the trial court was correct in finding that the taxpayer came more within the classification of dealer than either trader or investor. To the extent that some language in *Chinook* can be read as obliterating the distinction between dealer and trader and as standing for the proposition that a sale of securities by anyone engaged in the securities business is a sale "to customers", it was rejected by the Seventh Circuit in *Faroll* v. *Jarecki*, *supra*, p. 287, which this Court cited with approval in *Factor* v. *Commissioner*, 281 F. 2d 100, 120 (1960), certiorari denied, 364 U.S. 933 (1961). See also *Van Suetendael* v. *Commissioner*, *supra*, p. 1077. That language in *Chinook* should not be followed here.

sale is to 'a customer'." Apparently, the taxpayer gained that impression from three sentences of our *Malat* brief in the Supreme Court which it quotes. (Br. 51–52.) Here is the footnote to that third sentence as it appeared in that brief (pp. 30–31):

> [26] As pointed out *supra*, p. 14, fn. 10, the words "to customers" and "ordinary" were added to the statutory language in 1934 in order to prevent people who were actively trading in the stock market from contending that their activities were sufficient to constitute a trade or business and thus permitting them to deduct stock market losses suffered during the depression as ordinary rather than capital losses. Since stock market speculators sell a fungible item to buyers they never see, Congress believed that requiring a sale to be not merely "in the course of business" but also "to customers" would exclude them. While the original purpose of the 1934 amendment was "to prevent tax avoidance" by "a stock speculator trading on his own account," S. Rep. No. 558, 73d Cong., 2d Sess., p. 12 (1939–1 Cum. Bull. (Part 2) at 595; H. Conf. Rep. No. 1385, 73d Cong., 2d Sess., p. 22 (Amendment No. 66) (1939–1 Cum. Bull. (Part 2) at 632), the amendment created a permanent exception to the general rule that if a taxpayer's activities are sufficient to constitute a business his normal gains will be taxed as ordinary income. (Thus today even an active securities trader is entitled to capital gain treatment.) Therefore, in the context of a taxpayer actively engaged in the real estate business, the words "to customers" add little to the statutory requirement that the

sales be in the ordinary course of his business. [Citations omitted.]

Finally, it should be noted that we are here dealing rith an amendment by Congress designed to reach he very type of transactions involved in this case. ıdded during the depression to halt a revenue loss rom excessive deductions of securities losses by non-ealers, that amendment has probably operated in the ntervening years to produce a net revenue loss by its referential treatment of gains. The irony has not scaped the Internal Revenue Service.[8] It is doubtful hat this taxpayer would have protested the classifica-ion of its securities as capital assets had their sale esulted in long-term gains. But the rule cuts both rays. The adverse consequences of that same rule an not be avoided merely because the taxpayer is now aced with losses. Perhaps the general rule that se-urities are capital assets to non-dealers (Br. 36) should not be the law." Nevertheless, any change hould properly come from Congress.

I. The District Court correctly held that federal stock transfer taxes paid on the purchase and sale of capital assets are not currently deductible expenses

The taxpayer claims also that it should receive cur-ent deductions for federal stock transfer taxes it aid for 1962 on the purchase and sale of securities

[8] The contention of the Internal Revenue Service, in years ast, that ordinary income was generated from the profitable ıle of securities or similar assets by traders met with a con-istent lack of success. See *e.g. Kemon* v. *Commissioner*, 16 '.C. 1026 (1951); *Wood* v. *Commissioner*, 16 T.C. 213 (1951). 'he Commissioner of Internal Revenue acquiesced in both ad-erse decisions. 1951-2 Cum. Bull. pp. 3, 4.

(Br. 55–56).[9] The District Court correctly held that the payments were not currently deductible. (R. 243, 283.)

The only authority cited by the taxpayer is *Hirshon* v. *United States,* 116 F. Supp. 135, superseding, 113 F. Supp. 444 (Ct. Cl., 1953). There, the court held that a taxpayer which (as this taxpayer) was a trader in securities could deduct the federal stock transfer taxes it paid on the theory that such a tax is deductible as a business expense by one engaged in the business of buying and selling stock. In our view, the *Hirshon* theory falls short of supporting the conclusion.[10] Assuming that a securities trader is in the trade or business of buying and selling securities, it by no means follows that every expense of that business is deductible under Section 162 of the Internal Revenue Code of 1954. An expense of a business may be a capital expenditure, for example, and therefore not currently deductible. As this Court held in *Spangler* v. *Commissioner,* 323 F. 2d 913, 918 (1963), the principle that capital expenditures are not currently deductible is a "basic limitation" on deductions under Section 162.

Costs directly connected to the acquisition and disposition of capital assets are the clearest sort of capi-

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[9] The federal stock transfer tax provision was contained in Section 4321, Internal Revenue Code of 1954. Congress repealed that Section effective as of January 1, 1966. Excise Tax Reduction Act of 1965, P.L. 89–44, 79 Stat. 136, 148.

[10] The Internal Revenue Service has ruled that it will not follow *Hirshon.* Rev. Rul. 55–756, 1955–2 Cum. Bull. 536. The standard federal income tax treatise refers to *Hirshon* as a "questionable decision". 5 Mertens, Federal Income Taxation (1964 ed.), Sec. 27.20, fn. 23.

tal expenditures. *Spangler* v. *Commissioner, supra.*, p. 921; *United States* v. *Akin,* 248 F. 2d 742, 744 (C.A. 10th, 1957); *Godfrey* v. *Commissioner,* 335 F. 2d 82, 35 (C. A. 6th, 1964); *Willcuts* v. *Minnesota Tribune Co.,* 103 F. 2d 947, 950 (C. A. 8th, 1939). As we have shown, the securities in this case are capital assets. Like commissions,[11] a federal stock tax that is payable only if the stock is transferred can hardly be more directly connected to the acquisition and disposition of stock. Therefore, the federal stock transfer taxes in this case are capital expenditures which should be added to the basis of the securities and treated the same as the underlying asset rather than be deducted currently.

The disallowance of a current deduction to a non-dealer for the payment of federal stock transfer taxes is supported by authority. Prior to 1944, federal stock transfer taxes (stamp taxes) were deductible as taxes. See *e.g.* Revenue Act of 1938, Sec. 23(c), c. 289, 52 Stat. 447, 460, Sec. 23(c). In the Revenue Act of 1943, Congress amended that section to provide that deductions were not allowed for "Federal * * stamp taxes" and added the sentence "but this subsection shall not prevent such * * * taxes from being deducted under subsection(a)" (the predecessor to the present Sections 162 and 212). Revenue Act of 1943, Sec. 111, c. 63, 58 Stat. 21, Sec. 111. By that amendment, Congress did not intend that such taxes would be deductible under Section 162 in all cases—

[11] *Helvering* v. *Winmill*, 305 U.S. 79 (1938); *Spreckels* v. *Commissioner*, 315 U.S. 488 (1942), affirming, 119 F. 2d 667 (C. A. 9th, 1941).

e.g., if they were properly capital expenditures—or Congress merely provided that "*this* subsection" would not prevent taxes from being deducted under Section 162. That language cannot be fairly interpreted to mean that such taxes *shall* be deducted even though they fail to qualify as deductions under the rules normally applicable to Section 162.[12]

In interpreting that amendment, the Internal Revenue Service has ruled that federal stock transfer taxes are deductible only by a dealer and not by a trader or investor. I. T. 3806, 1946–2 Cum. Bull. 4; Mim. 6367, 1949–1 Cum. Bull. 63. That position has been approved by the Tax Court. *Standard Linen Service, Inc.* v. *Commissioner,* 33 T.C. 1 (1959); *Maytag* v. *Commissioner,* 32 T.C. 270 (1959); See

[12] The legislative history of the income tax treatment of federal stock transfer taxes should be compared with recent legislative history concerning state taxes. Prior to 1964, stock transfer taxes imposed by states were deductible under Section 164(a) of the Internal Revenue Code of 1954. That section was amended by the Revenue Act of 1964 with the result that such state taxes are now deductible under Section 164 only if they are incurred in a trade or business or for the production of income. Section 207(a), Revenue Act of 1964, P.L. 88–272, 78 Stat. 19. In contrast to the income tax treatment for federal stock transfer taxes, Congress provided that *state* stock transfer taxes which qualify under Section 164 are to be deducted currently—even though they might otherwise be capital expenditures. The Senate and House committee reports on that Act contain the identical statement that state taxes (including state stock transfer taxes) "may be deducted as taxes when they are of a business nature or for the production of income even though otherwise they might have to be capitalized". S. Rep. No. 830, p. 55, 88th Cong., 2d Sess. (1964–1 Cum. Bull. (Part 2) 505, 559); H. Rep. No. 749, p. 50, 88th Cong., 1st Sess. (1964–1 Cum. Bull. (Part 2) 125, 174).

generally, 5 Mertens, Federal Income Taxation (1964 ed.), Sec. 27.20.

CONCLUSION

For the reasons stated, the decision of the District Court should be affirmed.

Respectfully submitted.

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NOVEMBER 1966.

CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19, and 39 of the United States Court of Appeals for the Ninth Circuit and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated: ———— day of ————————, 1966.

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APPENDIX

Internal Revenue Code of 1954:

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) *In General.*—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

*   *   *   *   *

(26 U.S.C. 1964 ed., Sec. 162.)

SEC. 164. TAXES.

(a) *General Rule.*—Except as otherwise provided in this section, there shall be allowed as a deduction taxes paid or accrued within the taxable year.

(b) *Deduction Denied in Case of Certain Taxes.*—No deduction shall be allowed for the following taxes:

*   *   *   *   *

(3) Federal import duties, and Federal excise and stamp taxes (not described in paragraph (1), (2), (4), or (5)); but this paragraph shall not prevent such duties and taxes from being deducted under section 162 (relating to trade or business expenses) or section 212 (relating to expenses for the production of income).

*   *   *   *   *

(26 U.S.C. 1964 ed., Sec. 164.)

SEC. 172. NET OPERATING LOSS DEDUCTION.

*   *   *   *   *

(c) *Net Operating Loss Defined.*—For purposes of this section, the term "net operating loss" means (for any taxable year ending after December 31, 1953) the excess of the deductions allowed by this chapter over the gross in-

come. Such excess shall be computed with the modifications specified in subsection (d).

* * * * *

(26 U.S.C. 1964 ed., Sec. 172.)

SEC. 1211. LIMITATION ON CAPITAL LOSSES.

(a) *Corporations.*—In the case of a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of gains from such sales or exchanges.

* * * * *

(26 U.S.C. 1964 ed., Sec. 1211.)

SEC. 1221. CAPITAL ASSET DEFINED.

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

* * * * *

(26 U.S.C. 1964 ed., Sec. 1221.)

Treasury Regulations on Income Tax (1954 Code):

§ 1.471–5 Inventories by dealers in securities.

A dealer in securities who in his books of account regularly inventories unsold securities on hand either—

(a) At cost,

(b) At cost or market, whichever is lower, or

(c) At market value,

may make his return upon the basis upon which his accounts are kept, provided that a description of the method employed is included in or attached to the return, that all the securities are inventoried by the same method, and that such method is adhered to in subsequent years,

unless another method is authorized by the Commissioner pursuant to a written application therefor filed as provided in paragraph (e) of § 1.446–1. A dealer in securities in whose books of account separate computations of the gain or loss from the sale of the various lots of securities sold are made on the basis of the cost of each lot shall be regarded, for the purposes of this section, as regularly inventorying his securities at cost. For the purposes of this section, a dealer in securities is a merchant of securities, whether an individual, partnership, or corporation, with an established place of business, regularly engaged in the purchase of securities and their resale to customers; that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom. If such business is simply a branch of the activities carried on by such person, the securities inventoried as provided in this section may include only those held for purposes of resale and not for investment. Taxpayers who buy and sell or hold securities for investment or speculation, irrespective of whether such buying or selling constitutes the carrying on of a trade or business, and officers of corporations and members of partnerships who in their individual capacities buy and sell securities, are not dealers in securities within the meaning of this section.
(26 C.F.R., Sec. 1.471–5.)

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